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UNCLAS SECTION 01 OF 02 PRETORIA 005009

SIPDIS

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DEPT FOR AF/S/MTABLER-STONE; AF/EPS; EB/IFD/OMA
USDOC FOR 4510/ITA/MAC/AME/OA/JDIEMOND
TREASURY FOR OAISA/JRALYEA/BCUSHMAN
USTR FOR PCOLEMAN

E.O. 12958: N/A

TAGS: [ECON](#) [EINV](#) [EFIN](#) [ETRD](#) [BEXP](#) [KTDB](#) [PGOV](#) [SF](#)
SUBJECT: RAND SETTLES DOWN IN 2005

REF: A) PRETORIA 1959, B) PRETORIA 4936

¶1. Summary. In 2005 the South African rand has shown less volatility than in the previous three years, prompting speculation that the rand will settle around a relatively narrow range of R6.35-6.70 per dollar for 2006. Increased liquidity has helped, with the average daily turnover in the country's foreign exchange market has increased from \$3.8 billion in the first quarter of 1998 to \$13.8 billion in the third quarter 2005. Improved credit ratings and growth prospects have also helped stabilize the rand, along with increased foreign direct investment in 2005. Monetary policy has kept inflation under control, with the consumer price index measure monitored by the South African Reserve Bank within its 3% to 6% target range for 27 straight months. With commodity prices expected to remain high and growth prospects favorable, the rand should become more stable, perhaps attracting even more foreign investment.
End Summary.

Rand Instability: Is it History?

¶2. The South African rand has lost about 12 percent against the dollar in 2005 to date, its first depreciation over a calendar year since 2001 and a relatively mild move after three straight years of hefty gains. In 2002 it increased 40% against the dollar, in 2003 it added 28% and last year it increased another 18%. The rand's swings have also moderated recently. In 2005 it ranged between a high of 5.617 to the dollar, reached early in January, to a low of 6.977 in June, a difference of 136 rand cents. In 2004 its range was about 200 rand cents, in 2003 almost 300 rand cents and in 2002 it was 410 rand cents. In December 2001, when it sank to 13.84 to the dollar, the currency was extremely volatile, gaining around 200 rand cents alone in the last 10 days of the year. In 1998, when the Asian currency crisis hit, the rand's range was only 200 rand cents between its high and low, illustrating that 2005 might be the beginning of a stable rand.

Increased Liquidity

¶3. Increased liquidity has helped the rand to stabilize. According to the South African Reserve Bank (SARB), the average daily turnover in the country's foreign exchange market has increased from \$3.8 billion in the first quarter of 1998 to \$13.8 billion in the third quarter of 2005. In fact, the rand is the most actively traded emerging market currency. Some of this increase may be due to speculation

as growth in trade and the economy, while brisk, has not matched growth in foreign exchange liquidity. Moreover, the increased size of the market has made it more difficult for speculators to dramatically influence the value of the rand. In the past, the rand has been most erratic when trading is low.

¶4. Deepening liquidity also points to growing confidence in a well-managed economy. Fiscal deficits have remained low and inflation targeting has kept interest rates within the 3% to 6% targeted range for the past 27 months. Since 2000, the deficit to GDP ratio has remained below 2.5%, reaching 2% by year's end in 2004. In the third quarter 2005, it had reached 1.5%, due to higher than expected revenue collection.

Better Growth Prospects

¶5. The rand has stabilized recently, even though current account deficits are on the increase. The ratio of current account deficit to GDP has steadily increased from -1.3% in 2003 to -4.7% in the third quarter 2005 (all quarters in 2005 have been above -3.7%). Better growth prospects in 2005 have attracted foreign inflows. Increased foreign direct investment inflows have included British bank Barclays purchase of a controlling stake in local bank ABSA, worth over \$4 billion and British cellular group Vodafone's 50% purchase of South African cell phone provider Vodacom, worth \$2.4 billion (Reftels). In August 2005, international ratings agency, Standard & Poor's, upgraded South Africa's currency, putting South Africa's ratings at BBB+, one notch below the A category. Moody's upgraded South Africa's credit ratings in January 2005 and Fitch has put South

PRETORIA 00005009 002 OF 002

African on positive ratings watch, indicating that an upgrade could come later.

¶6. Commodity prices have remained high in 2005 and should remain high. The gold price reached \$500 in early December and in recent trading remains above \$500. South Africa's economy is expected to grow by 5 percent in 2005 after expanding 4.5 percent in 2004. The South African government wants to double the long run growth rate from 3% to 6%. Detailed plans on how to achieve this should be released in January 2006. However, current demand trends should support GDP growth over 4%. Both consumption and investment show strong gains. In 2004, growth in household consumption and capital formation reached 6.5% and 8.8%, with third quarter 2005 growth at 6.1% and 7.1%, respectively. The black middle class has grown by 30% in the past 12 months, increasing the black's population share of South Africa's middle class to almost one third, according to the 2005 All Media and Product Survey. Between 1993 and 2003, though the demographic composition of the population remained the same, black household's contribution to total household expenditure increased from 36% to 46%, making blacks the country's biggest consumer base. Consumer demand growth prospects remain good.

¶7. Comment. Currency stability remains important for foreign investors. Up to now, most foreign investment has been portfolio inflows, although direct investment in South Africa has increased substantially over the past year. High commodity prices, improved growth prospects, increased foreign liquidity and improved credit ratings have all led to a more stable rand in the past year. To achieve a 6% long run growth, South Africa needs more foreign direct investment and a more stable rand can only help.

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